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SUBJECT: BANGLADESH: IMF CONDUCTS FIFTH REVIEW OF PRGF

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CLASSIFIED BY ECON CHIEF DAVID RENZ REASON 1.4(d)

¶1. (C) Summary: An IMF mission conducted the fifth review of Bangladesh's Poverty Reduction and Growth Facility (PRGF) from April 30 - May 10. Although identifying several actions the BDG must take, the IMF mission was generally satisfied with progress to date. Key issues are reducing fuel price subsidies and increasing revenues. Executive Board consideration of the fifth review could take place in July 2006 and, if approved, would permit release of an additional $90 million in PRGF funding. If consideration is delayed to the September meeting, it is unlikely a sixth review would take place before the PRGF expires at the end of 2006. IMF will wait to negotiate a new PRGF until a new government is formed following elections expected in January 2007. End summary.

¶2. (U) On May 14, IMF resident representative Jonathan Dunn briefed members of the diplomatic community regarding the IMF fifth review of its PRGF with Bangladesh. He began with a summary of the points contained in a May 10 IMF press release
(http://www.imf.ogr/external/np/sec/pr/2006/p r0693.htm):

-- The economy continues to grow despite stiff competition in the global garment industry. IMF projections of 6.5% real GDP growth for FY 2006 (July 1, 2005-June 30, 2006) are consistent with recent ADB projections. Inflation is contained and the international reserve position is stable.

-- The BDG continues to pursue prudent fiscal, monetary and exchange rate policies. Lower expenditures, particularly for the Annual Development Program (ADP) have offset lower revenues, limiting domestic financing needs to 2% of GDP. The financial condition of several large state owned enterprises (SOEs), however, has markedly deteriorated. The mission welcomed the momentum behind reforms of the Nationalized Commercial Banks (NCBs).

-- Bangladesh Bank (the central bank) has gradually tightened

monetary policies to reduce inflationary pressures. The floating exchange rate system is functioning well and depreciation of the real effective exchange rate has improved export competitiveness.

-- Several challenges threaten continued economic progress. Power shortages threaten near-term economic growth. Current energy pricing policies and deterioration of the financial position of SOEs pose risks to the government's fiscal position and the banking system. Further improvements in revenue collection and project implementation are needed to sustain fiscal stability and enhance poverty reduction.

-- Bangladesh cannot sustain the financial losses and economic costs stemming from under-pricing of energy products -- fuel, electricity and natural gas. Reforms aimed at eliminating general subsidies while targeting support to the most vulnerable should be implemented.

Macro Economy Performing Well

¶3. (U) Dunn reviewed several key economic indicators. Real GDP growth is now estimated at 6.5%, up from 5.6% for FY06. Inflation is moderate at 6.25% (year-on-year) in March 2006, down from a near 8% peak. Overall revenues and expenditures as a percent of GDP are nearly unchanged from FY06. Revenues are 0.4% less and expenditures are 1% less than initial forecasts. As a result, net financing requirements are also constant, at 3.4% of GDP. Export growth has outpaced the growth of imports while remittances remain strong. As a result, the balance of payments deficit is a mere 0.2% of GDP. Official reserves are essentially unchanged from FY06 at 2.4 months of imports of goods and nonfactor services.

¶4. (U) The key factors contributing to higher GDP growth, according to Dunn, are better than expected agricultural production, which rebounded from damage caused by the previous year's floods, strong performance of the ready-made

garment sector following the end of the Multi-Fiber Arrangement, and broad-based growth in manufacturing and services.

¶5. (U) Revenue growth as a share of GDP is flat. Income and domestic VAT tax collections are up 20% in real terms, according to Dunn. These gains were offset by lower revenues from customs and supplementary duties and VAT on imports, which Dunn attributed to lower import levels and corruption.

¶6. (C) Dunn noted several positive developments at the National Board of Revenue. He described a "change of mindset" at the NBR, which he attributed to the leadership of the current chairman. As a result, NBR recognizes it needs to reorganize along functional lines (e.g., auditing, collections, enforcement) instead of its current organization by type of revenue collected. He also pointed to growing cooperation among the large taxpayer units (LTUs) in current tax units, which focus compliance investigations on apparently wealthy individuals and businesses known to pay little or no taxes. Dunn cautioned that the current chairman will leave in August. If the reforms continue, Dunn expects them to have a real impact within two to three years.

¶7. (U) Expenditures are also flat as a share of GDP, although they had been projected to increase over FY05 levels. Dunn attributed this principally to ADP expenditure shortfalls. This has also resulted in a reduced flow of foreign assistance to fund ADP projects, which the government has been slow to implement. Procurement issues, especially in the power sector, have slowed implementation significantly.

¶8. (U) Remittances continue to grow and are projected at $4.8 billion for FY06. Dunn said it was unclear how much of

the increase reflects real growth and how much a shift from the informal to the formal sector. Some bankers, he said, believe the effect of "formalizing" remittances is diminishing. He also noted that banks have become much more competitive with the informal sector, offering guaranteed two-day delivery and better exchange rate spreads.

Disturbing Trends

¶9. (C) Dunn noted several disturbing underlying trends. Credit growth remains strong, at 20% for the 12-month period ending in March. This is driving up deposit interest rates as banks look to raise funds to meet credit demands. Dunn also said the deposit rate spread among banks, currently 7%-13%, is also increasing, raising concerns that some banks may be engaging in risky lending practices, while using above average rates to compete for funds. He noted that the central bank is gradually tightening the money supply, but said he does not expect any major changes in monetary policy during the current government's remaining six months. He was neutral on the quality of central bank supervision of the banking sector and its ability to manage problems that may arise at any commercial banks.

¶10. (C) Dunn cited power sector problems (Ref B) as a major risk to growth over the next few years. While he discounted RMG sector claims that unstable power was causing a 30%-50% productivity loss, he conceded the sector was facing significant indirect costs for fuel for standby power generation and airfreight costs (versus sea freight) to meet delivery deadlines.

The Real Problem is Off the Books

¶11. (C) Dunn stressed that the real problem in the economy is the under-pricing of energy products, which is essentially financed off the books through the national commercial banks and the main SOEs, especially the Bangladesh Petroleum Corporation. Although the major problem at the moment is fuel subsidies (diesel, gasoline and kerosene) (Ref A), under-pricing of electricity and natural gas contributed to under-investment in the power and energy sectors, Dunn said.

¶12. (U) Already facing popular discontent over rising prices for basic food items and frequent power outages, the

BDG has been reluctant to use existing pricing mechanisms to adjust the domestic price of fuels in response to rising international oil prices. As a result, fuel prices in neighboring India are 80% higher than in Bangladesh. This in turn has created significant incentives for smuggling, contributing to fuel shortages in boarder regions and inflating Bangladesh's import requirements.

¶13. (C) The BDG initially relied on the NCBs to finance its imports through loans to the state-owned BPC. Most of these loans were funded through Sonali bank, although BPC also took loans from Agrani and Janata. Sonali is now bankrupt and illiquid due to lending to the BPC. The BDG will have to recapitalize it with a combination of debt and equity and write off the loans to BPC. The BPC is no longer borrowing from Agrani and Janata, and existing loans will likely have to be reclassified as non-performing and probably written off. The BPC borrowing is also crowding out private investment, Dunn said.

¶14. (C) The BDG has exhausted its internal sources of financing. It has also been late on a few payments to Middle-Eastern lenders. It has nearly finalized a $250 million commercial loan with Standard Chartered at LIBOR 2, with payments deferred for nine months from the first transaction. This loan would see the BDG comfortably through the elections, leaving the problem for the next government.

Key Conditions for Fifth Review

¶15. (U) Dunn said there are two key conditions the government must meet before the fifth review can be put to the Executive Board. First, the fuel subsidy issue must be addressed. Second, the government must put forth meaningful measures for increasing revenues in the next budget cycle.

¶16. (C) The IMF wants to see substantial increases in fuel prices to reduce government subsidies. An 80% increase is needed to bring prices in line with India, although Dunn said increases of 40%-50% would probably satisfy the IMF for now. IMF estimates 60% of the current fuel subsidies benefit the top two quintiles, making the current subsidy highly inefficient. Instead, IMF would like to see the government use existing poverty support programs to target direct subsidies to the lower income populations most in need of assistance, mainly rural farmers. No doubt reflecting IMF advice, Finance Minister Saifur Rahman recently told reporters the cabinet has agreed to raise fuel prices as soon as a support program for the poor can be put in place.

¶17. (C) Dunn said the IMF mission met with the Awami League (AL) during their visit. They do not expect the AL to make a political issue out of any government fuel price increase. They realize, Dunn said, that they will also have to deal with the issue, if elected.

¶18. (C) On revenues, Dunn said the IMF is looking for a 0.5% of GDP increase in revenue projections. Of this, perhaps 0.2% could come from efficiencies and improved collections; however, the remaining 0.3% will require policy changes. The IMF is waiting for government proposals, which should be factored into the FY07 budget proposal scheduled to be presented June 9.
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